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- I. **2010 A Year of Uncertainty in Estate Taxation**
- II. **What Are OUR and THEIR Asset Allocations?**
- III. **Vanguard Rates of Return (through December 31, 2009)**
- IV. **Roth IRA Conversions—Changes in the Law for 2010**
- V. **Up the Creek When That Rainy Day Comes**

I. 2010 A Year of Uncertainty in Estate Taxation:

There are two big changes to federal estate taxation this year: (1) for 2010 only there is NO FEDERAL ESTATE TAX, and (2) accounting for assets inherited this year will be significantly more difficult than in the past. Here are a couple of excerpts from a memorandum, recently received, from a local family law firm on the subject:

First, it is important to determine whether your estate plan should be amended in order to ensure that your primary goals are accomplished if you should die during 2010. Wills or trusts that refer to the marital deduction, the federal estate tax, the unified credit, the estate tax exclusion amount, and/or the generation-skipping transfer tax should be reviewed promptly, because it may not be clear how a court would interpret a will driven by tax concepts that aren't effective during 2010.

[T]he tradeoff for repeal of the estate tax for individuals dying in 2010 is that beneficiaries of their estates will not have the income tax cost basis of assets adjusted (usually increased) to the value as of date of death. In other words, built-in capital gains will be passed along to beneficiaries and no longer forgiven at death. ...You should not be in any hurry to throw away financial records, since the factual investigations necessary to determine your cost basis of property held for many years will be impossible without such records. If your beneficiaries can't prove what you paid for an asset, the law effective in 2010 assumes your basis was zero, subjecting the full value of appreciated assets to capital gain tax when your beneficiaries sell.

Smartt Comment: I don't often rail against Congress and its members, (I had an uncle in Congress many years ago and I saw first hand how hard he worked and how difficult it was for him to get away from his work). For years legal and accounting professionals have had an expectation that Congress would act and that this would not become an issue, let alone the mess described above. If you need a referral to an estate/trust attorney, do not hesitate to contact me.

II. What Are OUR and THEIR Asset Allocations?:

Each of us has a different ability to live with uncertainty (risk) and so our investments will be different:

As of December 31, 2009	Clients	The Smartts
Money Market Funds	2.7%	0.8%
Bond Funds	31.3%	3.9%
Stock Funds	<u>66.0%</u>	<u>95.3%</u>
Totals	100.0%	100.0%

Remember each of us has different goals and needs and our asset allocation should fit us and our family.

III. Vanguard Rates of Return (through December 31, 2009):

Performance percentages are per Morningstar. Amounts in parentheses are percentile rankings (1= best and 100= worst) within category.

Periods ended December 31, 2009	Yr.-to-date	5 Years	10 Years
Total Stock Market Index	28.7% (41)	0.9% (38)	-0.3% (45)
Tax-Managed Capital Appreciation	29.0% (38)	1.0% (37)	-1.1% (59)
Tax-Managed Small Capitalization	25.6% (74)	1.4% (37)	6.5% (41)
REIT Index	29.6% (50)	0.6% (34)	10.4% (32)
Tax-Managed International	28.3% (63)	3.7% (42)	1.2% (38)
Balanced Index	20.1% (77)	2.9% (28)	2.6% (41)
Total Bond Market Index	5.9% (90)	4.9% (26)	6.1% (27)
High-Yield Corporate Bond	39.1% (82)	4.4% (58)	5.1% (54)

For comparison, here are several stock and bond benchmarks:

Periods ended December 31, 2009	Yr.-to-date	5 Years	10 Years
S & P 500 (large stocks)	26.5%	0.4%	-1.0%
Russell 2000 (small stocks)	27.2%	0.5%	3.5%
MSCI EAFE Index	31.8%	3.5%	1.2%
Barclays Aggregate Bond Index	5.9%	5.0%	6.3%
CS First Boston High-Yield Index (bonds)	54.2%	6.0%	7.1%

Vanguard mutual funds and ETFs continue to perform as expected.

The MSCI EAFE Index, added to the benchmarks section above, and added to client quarter ending reports at last year end, is designed to measure the equity [stock] market performance of developed markets, excluding the US and Canada. It consists of 21 developed market countries indices, including, Australia, France, Germany, Hong Kong, Italy, Japan, Sweden and the United Kingdom. It is a reasonably good fit for the Tax-Managed International fund owned by many clients.

Note that the rates of return for the Vanguard mutual funds in the table above are for the regular class of the fund. E.g. the Total Bond Market Index fund results included are for the regular, investor class fund which has annual operating costs of 20/100%. Most clients own, instead, the ETF version of the same fund with annual cost of 10/100%--half as much cost. The Total Stock Market Index fund above has operating costs of 16/100%, but "VTI" the ETF version of the fund has costs of only 7/100%. Thus most clients, through ownership of the lower cost version, earned slightly higher rates of return. Such slight savings in cost compound/multiply as the years roll on. Small differences in operating cost are expected to earn large differences in total investment value over long periods of years.

For some investors there are reasons to continue to own the investor, higher-cost class of these funds. First, the fund may have increased significantly in value since the purchase and be owned

within a regular, currently taxed account. Sale of the fund and purchase of the ETF might cause a taxable capital gain levy. Second, to change from the mutual fund to the ETF costs brokerage commissions, and such commissions, in relation to small holdings, may be high enough to wipe out projected mutual fund cost savings.

I'd be pleased to discuss your situation with you further.

IV. Roth IRA Conversions—Changes in the Law for 2010:

From *Kiplinger's Personal Finance Magazine*, the January, 2010 issue, here is much of what you need to know to consider Roth IRA conversions this year:

Good news: you're eligible. Until now only taxpayers with income of \$100,000 or less were permitted to convert a traditional retirement account to a Roth IRA. But the income eligibility limits on Roth conversions disappear on January 1 [2010] (income-eligibility limits on contributions remain in effect). That means that high earners can now hop on the tax-free-retirement-income gravy train.

And just in time. With federal budget deficits expected to top \$9 trillion over the next ten years, it's a safe bet that income taxes will increase to deal with the rising sea of red ink. Upper-income Americans, previously barred from funding Roth IRAs, are likely to bear the brunt of future income tax hikes. That makes a compelling argument for converting assets in traditional IRAs, which will be fully taxed when you tap them in retirement, to tax-free Roths. The catch is that you must pay income taxes at your current rate on any amount you convert. Plus, your Roth must be open at least five years before you can tap the converted amount penalty-free. After that, all of your Roth withdrawals, including earnings, are tax-free and penalty-free once you turn 59 ½ years old.

Plus, no payments for one year. If you convert to a Roth in 2010, you're entitled to extra time to pay your taxes. Although you will be taxed on the entire amount you convert, you can spread the bill over the next two years, reporting half of the conversion on your 2011 tax return (due in April 2012) and the balance on your 2012 return (due in April 2013). That gives you a lot of time to come up with the cash to pay your tax. This is not an all-or-nothing deal; you can convert a portion of your IRA at any time and pay the taxes as you go. But the option to spread the tax bill over two years is available only if you convert in 2010.

The Feds aren't going to hit the undo button. No need to worry that Congress will one day eliminate the tax-free Roth *after* you've paid your taxes. The taxes collected on Roth conversions are a moneymaker for the cash-strapped U.S. government. If Congress were to decide to kill the Roth, existing accounts would likely be grandfathered—or lawmakers would face a taxpayer revolt.

Smartt Comment: The ability to predict which taxpayers will face higher (or lower) taxes in future years is notoriously uncertain. Your tax bracket could change in retirement, for example.

Through experience, I know that, for many clients the issue is not changes in income tax rates, or their income tax rate in retirement versus current income tax rate, but the issue of **legacy**. After age 70.5 you must begin to take withdrawals from a regular IRA whether you need the money or not. There is no such withdrawal requirement for a Roth IRA. This means that, if you do not need the resources within a Roth IRA in retirement, it need not be depleted—it can exist untapped for many years. For those who can afford not to spend it, this gives investments owned within a Roth a long investment period holding period, which makes a Roth a great place to own stock.

And since investment gains within a Roth are not taxed, to either the owner, or the beneficiary, paying the income tax “up front” in a conversion, may be a good idea. A Roth is a great asset to bequeath to the next generation.

Note that a key to conversion being a good idea is the availability of assets, other than within the regular IRA, to be used to pay the resulting income taxes.

Your income tax preparor/expert should be consulted regarding, for example, your place within the various income tax brackets. I can assist your preparor as required.

V. Up the Creek When That Rainy Day Comes

Quoted in the November 16, 2009 issue of *Business Week*:

How well can Americans deal with a financial emergency? Almost half (46%) of 2,148 consumers surveyed recently said they weren't confident they could come up with \$2,000 within a month in a crisis—from savings, family, friends, credit cards, or other sources. Even among those earning \$100,000 to \$149,000 a year, almost 25% doubted they could raise it, according to The Personal Risk Assessment and Risk Literacy Survey, conducted by research firm TNS with academics from Harvard Business School and Dartmouth College. ‘We wanted to know if people could fix a broken car or furnace,’ says Harvard finance professor Peter Tufano, who adds that most studies he has seen measure ‘how much cash people have, not how much they can access.’ The survey results surprised him. ‘The ability to cope with emergencies is much less strong than we might have thought.’

Smartt Comment: We all have a lot to be thankful for. Children of depression era parents are often better equipped to deal with the ups and downs of family financial life since our parents were such intrepid savers. Other generations appear not to be as fortunate.

During the “stock market unpleasantness” of the last couple of years, I have sought to quiet the uncertainties of my clients by reminding them that we generally keep a five year supply of anticipated spending in bond investments; therefore we don't expect to sell stocks to obtain money when stocks are low in value.

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